

October 14, 1977

LETTER 711

Sept. 30, DJIA 847.11; PTI 833; A-D Ratio -20.04

Oct. 7, DJIA 840.35; PTI 825; A-D Ratio -19.93

COMPLACENCY: It's positively amazing, but with the Dow down around 180 points from its high, the public, the traders, stockholders, **refuse to grow fearful**. Why are we waiting for fear and loathing on Wall Street? Because when fear rises, when it reaches crescendo proportions, stocks are jettisoned accordingly. At the "over-sold point," which is the point we have been waiting for, the worst has been discounted in the price structure and at that level, we know that the market is ready to turn—to the upside.

But bottoms aren't formed amid complacency. And markets don't turn up while the public is still smiling. In the last report I said that I expected the situation to turn black as the bottom arrives. Well, the news is certainly turning gray (not yet black), but ironically the public is still complacent. We have a dollar that's sliding, whopping trade deficits, a climbing gold price, rising interest rates, a President who nobody can understand (and a President who doesn't seem to understand anything), a balking Congress, and a total state of confusion about taxes, oil, Panama, business and just about everything else.

In the face of all this, stockholders simply refuse to panic. October is the month that I thought would see heavy selling and a bottom. And it may yet happen this month. But the odd-lot figures certainly don't show it, and my two indicators, the "market trend" and the most-active index (see chart on page 2) are still far from providing over-sold readings.

In the meantime, we have the two September lows to watch in the Averages, 212.75 for Transports and 835.72 for Industrials.

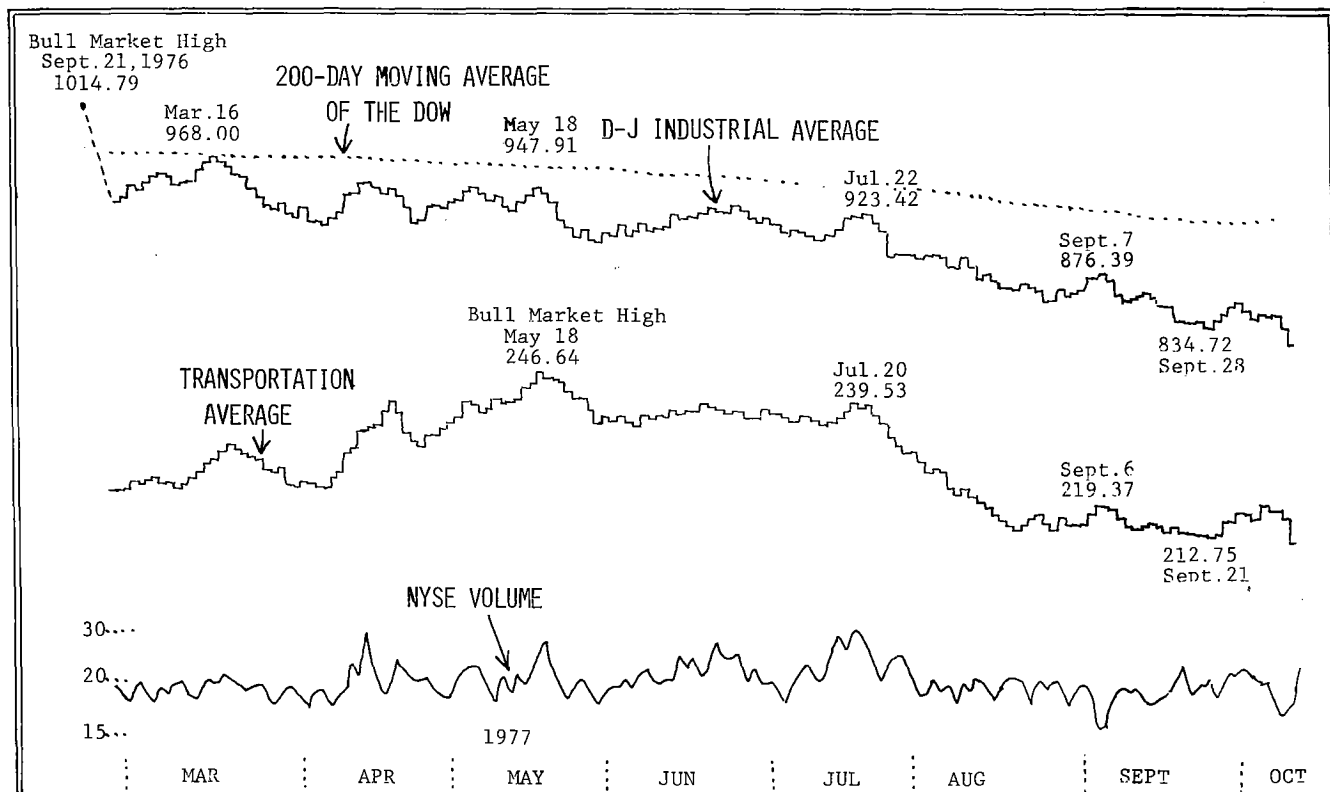
A breaking of these two lows should send the whole market lower—and hopefully to a good bottom. So let's let the market tell its story—while we keep our powder dry.

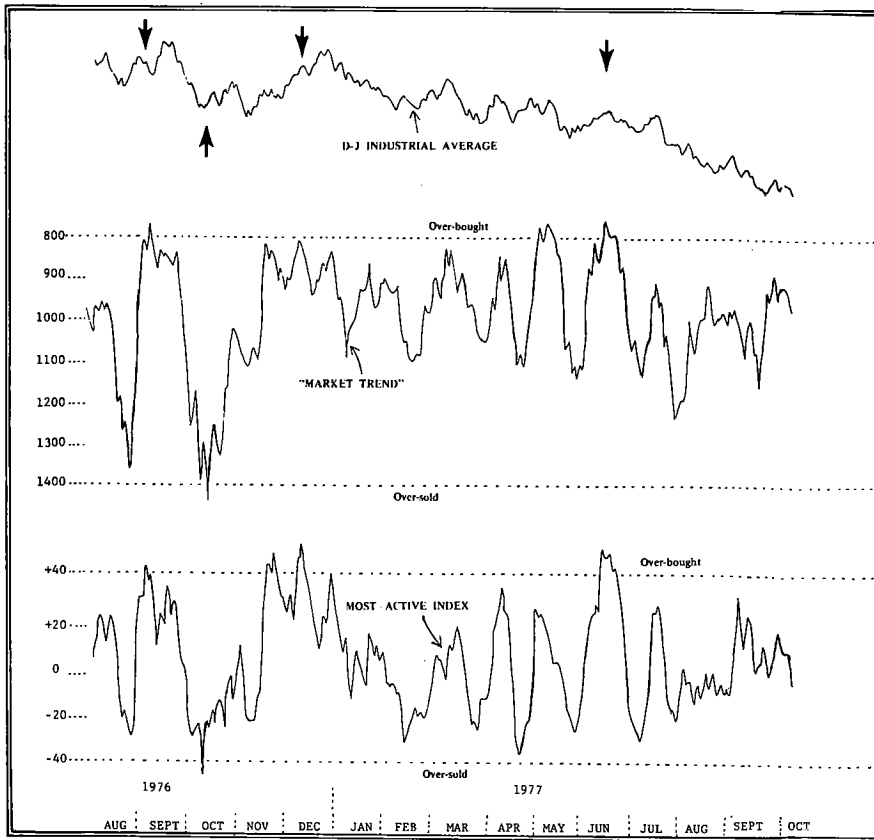
THE MARKET: A few months ago I referred to 1977's failure to produce so much as a 5% rally in the Dow. At this time, the situation is even more extraordinary (from an historical standpoint). Almost 10 full months have elapsed so far in 1977. And the Dow still hasn't produced even a 5% rally! There's never been such a sub-standard performance in the Dow in this century. Going back to 1900, we've never had a January to October period without a rally of at least 5% in the senior Average.

Why, what, how can this be? What is behind this mysterious, dismal performance of the Dow? A number of items (best taken together) have been responsible for the Dow's long fainting spell.

(1) Oil prices and the massive US deficits are probably the prime cause. As I see it, the fantastic deficits that we are now producing **MUST STOP**. They can only be stopped by a slash in the price of Arab oil or a slash in US consumption of oil (that's a polite way of saying that if we don't break the Arab cartel, they will break us). So far, I don't see a hint of progress for the US. But the market knows that a finale must come.

Meanwhile, the dollar has plunged against hard currencies, while gold spurts upwards. "But the dollar is intrinsically cheap," you argue. And there's no doubt about it, five bucks still buys a good meal in the US while you can't buy much of anything with a comparable amount of francs in Zurich or Paris. But look at it





this way. A Cadillac is a fine car, yet if you threw 10 million of them on the market, the price of Cadillacs would buckle. And that's what's happening to the dollar.

(2) The Less-Developed Nations (LDC's) are broke or almost broke. They are going under via oil deficits. US banks are loaded with LDC loans. That makes many banks vulnerable. Then there's another problem. The LDC's must raise money to service those loans (forget about paying them off). And raising money, as far as the LDC's are concerned, means selling their commodities AT ANY COST. That puts steady pressure on commodity prices; steady, fundamental, long-term pressure. And that's deflationary.

(3) We have a President in the White House who, in my opinion, doesn't understand capitalism (free enterprise is a nicer term). Carter understands votes, and he understands that there are more poor voters than rich voters. He also understands that there are a lot more citizens than there are corporations. To give Carter credit, I believe he is a compassionate man. But compassionate doctors give methadone to heroin addicts and such "treatment" just prolongs the mess. Instead of a heroin addict, you then have a methadone addict. In the same way, handouts to Americans aren't going to solve a thing, and I don't care how big Jimmy Carter's heart is. This nation needs corporate profits and capital formation, and Carter hasn't gotten that message yet. The D-J Industrials (in their 13 month decline) have been trying to give Carter the message, but so far—zilch.

I lump the new tax proposals in with the Carter syndrome. Obviously, the specter of the elimination of favorable capital gains treatment scares Wall Street and every other street where a paper profit resides. But then the average American has no capital gain. So why the devil should the "rich Americans" get all that special tax treatment? That's the way the populists think, and don't kid yourself, Mr. Carter is a populist.

Those are the great problems that I see facing this market. All three are solvable. But none of them have even begun to be solved. It doesn't matter whether you call yourself an optimist or a pessimist, what we need is problem solvers and straight talkers. And Washington doesn't seem to have any.

READY FOR ANYTHING: As subscribers know, I called a "probable bull market" in December, 1974 and told my readers, "Buy!" On January 17, 1975 I announced a *confirmed* primary bull market under the Dow Theory. As far as I am concerned, that bull market is still in force.

For a year now we have been bombarded with sundry bad news items. You name it, if it's negative, it's been happening. Under this steady barrage of unhappy developments, the market has been going down. This is not the way a bear market usually works. Bear markets move, and move fast. They are usually "well down there" by the time the rotten news starts emerging. That has not been the story in 1977.

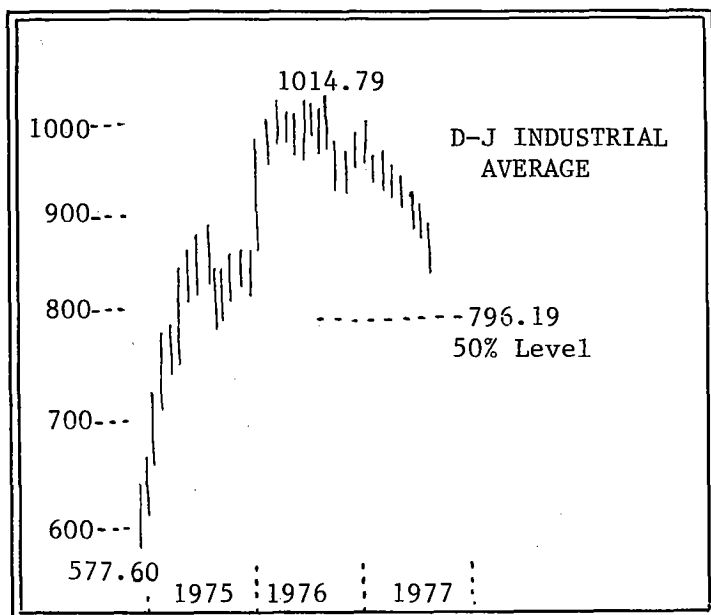
However, let it never be said that Richard Russell is a stubborn boob. A boob maybe—but not a stubborn boob. I am including two studies in the ensuing pages. One is a "failsafe" study based on the 50% principle. The second compares the action of the second phase correction of the 1932-37 market with the second phase correction of today.

If I am right, the Dow will produce an over-sold bottom and very hopefully, this side of 796.19. In that case, all systems should be "go" for this frustrating bull market. If I'm wrong—well, I want to be the first to know about it! And that's where the 50% Principle comes in.

THE 50% PRINCIPLE: This is a concept that I have been writing about (and using) for over 15 years. Charles H. Dow, first owner of the *Wall Street Journal*, noted that it is important what a stock or an average does at the halfway level of a preceding advance. This item was picked up by a few other analysts, but I really learned the application of the 50% Principle from E. George Schaefer, the late, great Dow Theorist.

This is the way the 50% Principle works. The main or primary trend of the market is taken to remain in force as long as **any correction holds above the 50% or halfway level** of the preceding major advance. Note that I use the adjective "major" to describe the advance. Some analysts make the mistake of trying to fit the 50% Principle to every minor movement. This is wrong. The 50% Principle works best when applied to an average, rather than to individual stocks. And the 50% Principle works best when applied to major, extended market movements. The longer the movement in time and duration, the more valid the 50% Principle.

I feel the 50% Principle can be applied to the current market, and the implications are well worth our studies. The current bull market started for the Dow in December, 1974 at 577.60. The high closing point for the Dow was reached on September 22, 1976 at 1014.79. The rise from 577.60 to 1014.79 was 437.19 points. The halfway or 50% level of the entire 1974-76 advance in the Dow is **796.19**.



Under the 50% Principle the 796.19 level is critical. As long as the Dow holds above that level, then under the 50% Principle the primary trend is conceded to be bullish. If the 1977 correction, for instance, can consolidate and build technical strength as it bottoms **above** 796.19, it will be very bullish. The implication will be that in due time the Dow (and most stocks) will climb to new recovery highs and the bull market will continue (perhaps for many months and even years).

On the other hand, if the 796.19 level is *decisively* smashed, I'm going to have to do some very heavy thinking and deciding. If I see the Dow plunge below the halfway or 50% level of the entire 1974-76 rise, I may decide that the primary bull trend has expired—and that a new bear market has Wall Street and the nation in its grip.

Question: Russell, why are you so tentative? Why don't you just state that if 796.19 breaks, we're in a bear market?

Answer: I distrust totally mechanical interpretations in the market. Of the 50% Principle George Schaefer once wrote, ". . . A caution, however—50 Concept is difficult to apply—by itself. There may be other technical indications . . . that the market move in question appears to have run its entire course."

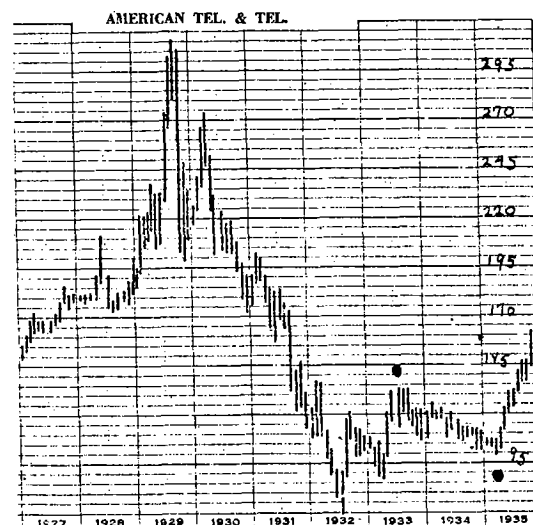
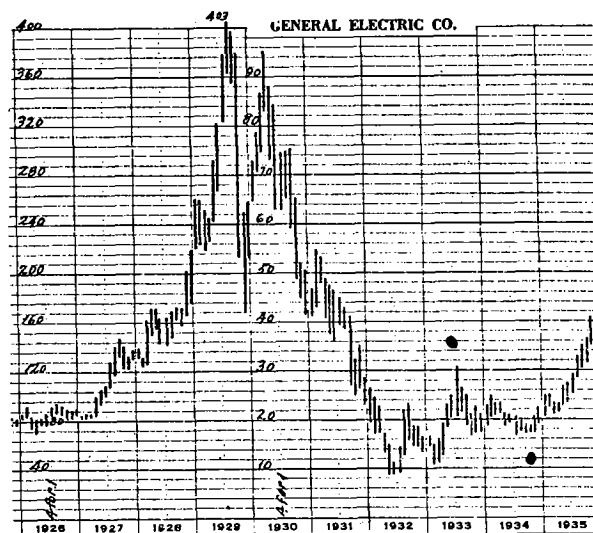
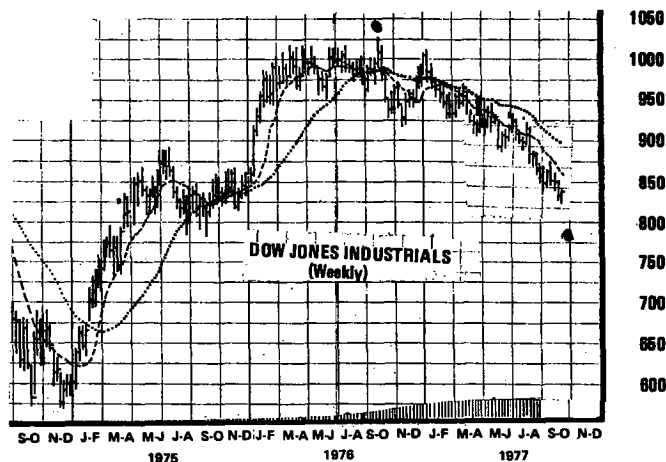
In other words, IF 796.19 is breached, I want to examine the technical situation **AT THAT TIME**. I would want to convince myself that the whole 1974-76 rise had been exhausted, that the technical situation is still poor, and that elements of a bear market are present. Conversely, if the Dow breaks 796.19 amid a fearful background, and in the face of a greatly strengthened technical situation, I would want to hold my final opinion in abeyance.

Conclusion: It would be a happy event if we could get a final bottom for the Dow and the market this side of 796.19. Such action would constitute a tremendous plus for the entire market picture. On the other hand, a decisive breaking of 796.19 by the Dow would find me very possibly revising my stand on this market. Nevertheless, if 796.19 is violated my subscribers would still find themselves in good shape. The reason is that we are in a very defensive stance with the bulk of our assets in bills, notes,

bonds and bond funds (with an optional 5% to 10% in gold in the form of Krugerrands).

COMPARISONS: History tends to repeat—but never in exactly the same way. That is one of the oldest truisms on Wall Street. Since 1974 I have on many occasions compared this market with the bull market of 1932-37.

Actually, there are interesting similarities. For instance, the 1974 bear market low came following the worst bear market



smash in 40 years. The 1932 bottom came after the worst crash in market annals.

The Dow lost 89% of its value during 1929-32. The unweighted indices lost over 80% of their values during 1968-74.

The 1929-32 crash came after a period of rampant speculation. Following the 1929 crash it was clear that "the New Era" was over. The 1973-74 crash was preceded by years of wild speculation. It is now conceded that the great "growth era" is about finished.

Following the July, 1932 bottom, the Dow exploded to a late-1932 high, thus ending the first phase of the new bull market. A correction carried into early-1933. This was followed by a second phase rise to mid-1933. Next came a long, dragged out second phase correction, a correction that carried into early 1935. From there (although nobody was ready to believe it at the time) the third phase advance erupted. It carried into early-1937.

In retrospect we see that the Dow rose from a 41.22 low in 1932 to a second phase peak of 108.67 in 1933. This 163% rise in a period of a year was too much for the Dow, and a long period of correction was necessary. I have shown that second phase correction period (1933-35) on the monthly charts of two famous Dow stocks, American Telephone and General Electric. Note that both of these stocks rose to their 1933 peaks in two steps, separated by a correction. The second phase peak is identified by the first (higher) dot on the chart.

Now note that Telephone entered into a long second phase correction, one that consumed 19 months. Telephone hit its bottom in early-1935. General Electric declined and corrected over a 16 month period, hitting its bottom in late-1934. Stock market students were generally convinced (in late-1934 and early-1935) that the bull market was over. Indeed many thought that the 1933-34 correction was simply a continuation of the 1929-32 bear market.

Then the third phase advance began. As you can see on the charts, both stocks took off in extraordinary advances that were to carry into late-1936 and early-1937. From its 1934 second phase low of 85.51, the Dow more than doubled to its March, 1937 peak of 194.40. And remember, all this occurred during the 1930's, when a business depression was in force much or most of the time.

Now turning to the current weekly chart of the Dow, note that we have had two swings up, ending with the 1014.79 peak of September, 1976 (first black dot on the chart). Since then, the Dow has been sinking much as it did during 1933-34. If I am right, what we have been seeing all during 1977 is a tedious, dragging second phase reaction, a slide that is correcting the 75.7% rise in the Dow (from 577.60 to 1014.79). Ultimately, the Dow (now in its 13th month of decline) will discount the worst that lies ahead. That will end the correction.

Following this correction, I expect to see the start of the third phase of the bull market. How far that will take the market, how much speculation will appear, how individual stocks will act, I cannot tell at this time (obviously). But I do think we will see a good deal of upside action and I do think we will see speculation (even rampant speculation). Furthermore, I think the third phase could last all through 1978 and well beyond.

KEEPING MY COOL: Open any financial magazine, talk to any goldphile, read any "hard-money" report, and you're ready to crawl into a hole somewhere and hide for the duration. For instance, I include this chart from the late-September issue of *US News & World Report*. It's a chart showing the skyrocketing totals of Federal Employee's salaries. The chart doesn't need any comment, and I won't offer any. But put this chart together with one on Federal Deficits or Federal expenditures or military costs or any of a hundred other items, and you have to ask one question: "How much longer can the US survive?"

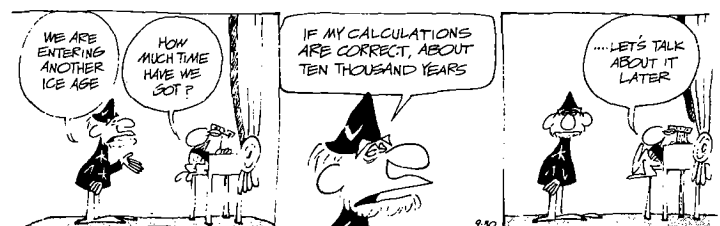
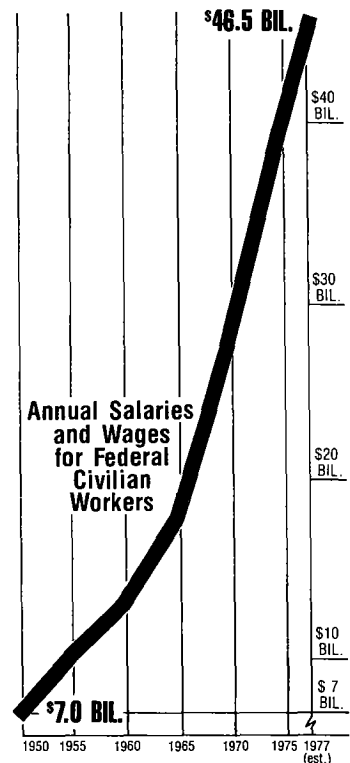
In other words, a thinking man, a man who can read and comprehend, has to have the

most serious doubts about where this nation is going and how it can continue to do what it's doing. I find that if I linger on this whole subject too long, I go into a slump. I start mumbling and ranting, and the first thing I know I have to get out and take a walk with my dog.

What I'm saying is that a thinking person has to have enormous doubt regarding the outcome of this nation's economic situation. To know the facts is to be a pessimist. Social Security is going, the dollar is going, the American work ethic is going, our technological lead is going, our assets are going, and on and on.

Against all this, I personally have to deal with the nearer term, the facts of whether we're in a bull or bear market, of whether the market is over-bought or over-sold, of "what do we do now?" After all, just because we're wrecking the country doesn't mean that we can tear up our bank books and lay down and die. Life goes on, we go on, and I have to continue writing my reports and trying to give my readers the best advice I can. Ironically, as I was writing this section this cartoon appeared in our local paper, and maybe the "Wizard of Id" says it better than I do. What's happening today and tomorrow is what I have to write about. What may happen next year or in 1984 can wait.

I always tell my "doomsday" friends (and I have a lot of them) that there is a point beyond which I refuse to worry. If the US is indeed going under, then I'm going down with the ship. I'll be damned if I'm going to move to the Canary Islands, and I'm not



going to send all my money to Switzerland, I'm not going to set up a dummy business in Bermuda, and I'm not going to write these reports from a cement bunker in Lichtenstein.

I may as well admit it right now—I've decided to stay right here in California and do my part to fight everything which I think is militating towards the destruction of free enterprise and democracy (yes, I do think there is a connection between the two). Frankly, I'm betting on this country, for if the US goes under, what's left? There's nowhere else to go (unless, of course my friend Harry Schultz comes up with a tax-free paradise island somewhere between here and the Coast of China.) But I don't like islands, I have a dread of tidal waves and hurricanes, I am afraid of poisonous snakes, rabid bats and carnivorous plants.

And this brings me to another thought which I want to get across to subscribers. Those Dow Transports—they hit a low of 203.85 last October 12, 1976. A year has now gone by, and the Transports just won't break the 203.85 low. After three decades of watching the market, I've learned never to ignore a situation where one Average refuses to confirm the indications of the other.

This market has had 13 months to discount bad news, confusing new tax plans, energy problems, sluggish business, you name it. Every magazine I pick up has a new story about the plight of business and the economy, and the magazines may well be right. But if things are so terrible, what's holding those Transports up? After all, the Transports are leveraged (with debt), they haul the freight that counts, they're highly sensitive to forthcoming business conditions. And in a poor year for the market, a year when the Dow hasn't (so far) rallied even 5%, those Transports are stubbornly respecting a low point which they recorded 12 months ago!

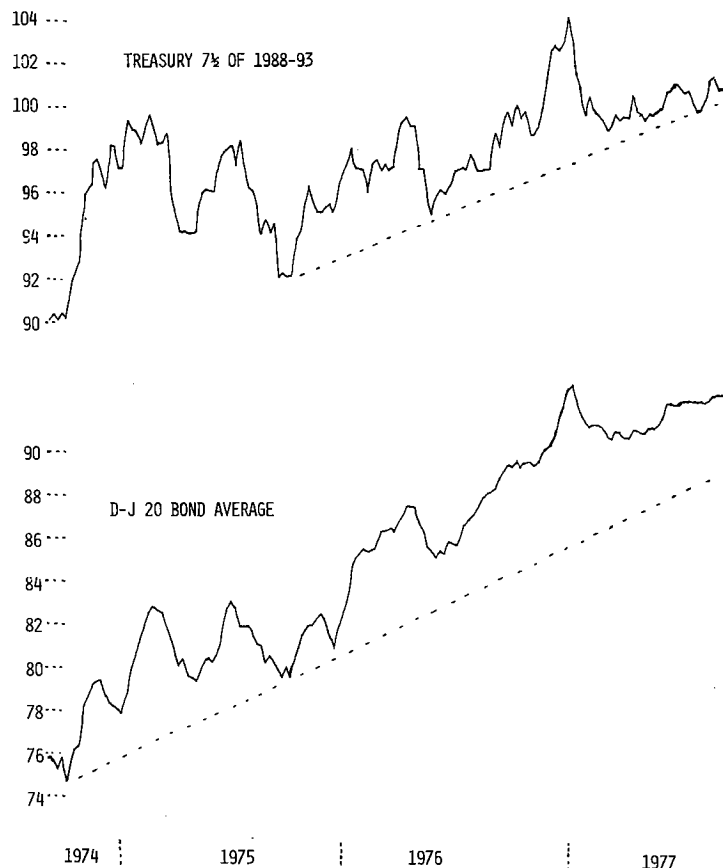
Here's what I think could happen. We could get an over-sold situation—with the general market down and the Transports still holding this side of 203.85. An **over-sold market within the context of a major non-confirmation** could represent a powerful launching pad. It could be the base which would propel this market into its final, speculative third phase.

Don't forget, under my interpretation we are still in a primary bull market. And the amazing non-confirmation on the part of the Transportation Average means that the market (from a Dow Theory standpoint) is resisting all-out decline. It also means that long-term technical strength is still there. The longer this decline continues in the face of the Transport non-confirmation, the greater the technical strength being generated. I liken it to a man pushing against a giant spring. The further he pushes, the more energy is being generated in the **opposite direction**.

Now from the standpoint of fundamentals, I don't know what elements could come together to give us a speculative third phase for this bull market. The third phase could be built simply on better business, it could be built on some kind of solution to the oil problem, it could be built on a flight from currency into stocks. I continue to believe that a third phase is coming. I feel that the refusal of the Transports to break 203.85 is telling us that.

But in the meantime **we need that over-sold situation**, that final decline that will complete a base and convince market

practitioners from New York to Seattle to Santa Fe that this is it—that the bottom has been seen.



BONDS: The Fed now faces a “hairy” situation. They have to deal with sluggish business and a huge series of US deficits (and huge deficits equal a weak dollar). The first calls for lower interest rates, the second calls for higher interest rates. The Fed is in the middle.

The immediate result has been a trend to higher short-term interest rates, with the bellwether 91-day Treasury bills now yielding about 6.1%. Meanwhile, the trend towards higher interest rates is starting to rub off on the (long-term) bond market, as you can see on my chart. The 7½ Treasury Bond of 1988-93, while still well above its 1976 lows, has broken a two-year trendline. The D-J 20 Bond Average (corporate bonds) is showing weakness but is holding well above its three-year trendline.

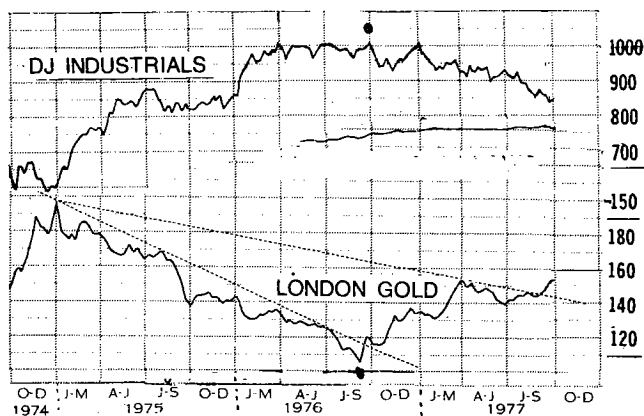
No one on this earth knows whether this is the beginning of real trouble in the money markets—or if it is just a correction, following three years of excitingly higher bond prices. I've pondered this bond picture for weeks, and frankly, I can't come up with the answer. But one thing is clear—many nations of the world are now surviving on the whopping US deficits. If we turned the deficits off (and I doubt we could), the rest of the world could settle into a severe recession. And if we don't, the dollar is going to continue under pressure.

When in doubt, hedge. And that is what I suggest now. You can hedge (protect your money position) in a number of ways. You can sell part or all of your Governments and move into T-bills. You can switch part or all of your Municipal bond funds into “liquid assets” funds (this merely requires a phone call).

Or you can sell options on Treasury bonds via the Chicago Commodity market (your broker can arrange this). These options run in units of \$100,000. If you have, say a \$100,000 in Bonds, you might sell an option so that if the bonds go down, your option will offset any loss, and you will continue still to collect your interest on the bonds.

As I said, no one can tell you what's ahead in the money markets. But certainly there is a good chance of rising interest rates to defend the sliding dollar. For that reason I would recommend hedging your bond positions at this point. I can't tell you whether to hedge 50%, 75% or all of your bond position, but I do say—move. This is something that requires action.

GOLD: Gold has moved up from its 1976 low of 103 to a recent 157. The gold rise began in August, 1976, one month before the September, 1976 top for the Dow. The Dow has been falling in the 13 months since September, 1976, while gold has been rising during the 14 months since August, 1976. The peak for the Dow and the low for gold are shown by dots on the accompanying chart (chart courtesy of CMI, 1133 N. Camano Dr., Camano Island, WA 98292).



My own guess is that this is not the "big gold move." The big one lies ahead. I believe that fears and doubts lie behind the 1976-77 gold rise. If and when the third phase of this bull market gets underway, confidence will very definitely increase, and I think that gold will then fall back (correct). But the gold correction, I feel, will hold above the 135 level.

It is when the third phase of this bull market is nearing its end that we will move into the gold market. At that time, I may well recommend a position of 50% or more in real gold, as represented by Krugerrands or other coins.

I want subscribers to get this concept fixed in their minds. **All investments provide yields.** If it hasn't got a yield, it's not an investment—but hopefully, it's a speculation. Now since gold provides no yield, it's a speculation. True, gold is considered a "store of value," but since every store of value can fluctuate in price, stores of value are also speculations.

Back in the pre-1971 period when gold was \$35 an ounce, all of us knew that gold was grossly undervalued. We bought it because we thought it was the "cheapest thing around." Not so today, gold is now probably near its intrinsic value in terms of dollars. True, the value of the dollar is sliding, and this means that it will probably take more and more dollars to buy an ounce of gold as the years go by. But this could be a gradual process, compared to the gold boom of 1970-74.

Thus, gold in 1977 at a price of 157 becomes a speculation, not the great **value** that it was a few years back when it was \$35. As such, we now have to trade gold, buy it at times, sell it at other times.

Right now, I believe stocks are becoming "the cheapest thing around." Stocks are intrinsically cheaper than gold, houses, stamps, coins, antiques, you name it. Stocks are very **out of favor** now. One reason is that corporations (and therefore, stockholders) have to face continuing Government interference in almost every phase of corporate existence (unlike owners of stores of value).

But just as nature heals and corrects, the market heals and corrects. At some point the outlook for corporations will improve. And the market will "see" that point, and it will stop going down. At that juncture, we'll buy stocks.

RUSSELL REASONS: I've tossed on my pillow for about two months over this market and economy, and I always come up with the same answer—the price of OPEC OIL MUST COME DOWN! I've worked up a few assumptions. (1) The Arab sheiks (being human) want to preserve their power. They have therefore hired the best economic and political advisors in the world. (2) The sheiks know the Free World is over a barrel (no pun) via oil prices and deficits. They know that the world economies and markets will smash if the deficits continue. (3) The sheiks rule "third world" masses. They therefore have to have good third world public relations. The sheiks have wanted to help the less-developed nations. But they didn't want their own money at risk. Consequently, they developed a brilliant plan. They told the US banks, "Look, we'll deposit billions of dollars in your banks. And you lend it out to the third world countries. We know that we're lending short and asking you to lend long. So if anything goes wrong, trust us. We'll get you off the hook." And the banks jumped at the chance. (4) The sheiks are now in the driver's seat. They hold the solution to the Free World's problems in their hands.

Do you know what I think? I think we're going to see "a deal" coming up, and it's going to come up amid world crisis, and it's going to be a bonanza for the Arabs. Now I don't know what the sheiks will ask—or how—or when. The Arab side of the deal will be a major drop in the cost of oil. When that happens, (1) the stock market will take off into its third phase, (2) world interest will come way down, (3) the dollar will sky-rocket and shorts on the dollar will be crucified, (4) the sheiks will be greeted as extraordinary statesmen. They will be international heroes. And let's see, I think the sheiks will want weapons, defense systems, technical know-how, boundary guarantees, the whole works. And if you're Jewish, you're not going to like this but Israel is probably going to have to go it alone (I suspect they're already getting ready to say "Goodbye, Uncle Sam.").

Sounds impossible, well I believe we're going to see it happen. I believe it, because the Arabs have played their cards beautifully so far, and the scenario outlined above would represent another perfect round for the sheiks. And oh yes, on October 11, Iran announced that she might drop the price of her oil 10%. Could that be a hint of things to come?

As this is written (Oct. 12), the market is down hard, and it feels like "the edge of panic." We're still not looking at an over-sold market, but the drama is beginning to unfold a bit faster here. I think the chance of an October bottom is pretty good. Let's hope so.

NEXT MAILING: October 28th